CHUKA **UNIVERSITY**

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 332: CORPORATE FINANCE

STREAMS: BCOM Y3 S1

TIME: 2 HOURS

DAY/DATE: WEDNESDAY 24/3/2021 **11.30 AM – 1.30 PM**

INSTRUCTIONS:

- Attempt Question one and any other two questions

Question One

a) Describe the 'information content' as applicable in dividend decisions. [4 Marks]

b) Liberty Holdings plc has 20 million ordinary shares of par value Sh.0.50 outstanding in issue trading on the Securities Exchange as Sh.1.60 per share. The directors of Liberty Holdings believe the company requires additional long-term capital and have decided to make a one-for-four rights issue at Sh.1.30 per share.
An investor with 2,000 shares in Liberty Holdings has contacted you for investment advice. She is undecided whether to take up the rights issue, exercises one half of the rights and sells the other half, or allow the rights offer to lapse.

Required

Evaluate each of the options being considered by the owner of 2,000 shares.[8 Marks]

c) Briefly explain any three reasons why a company may consider a bond refinancing decision. [6 Marks]

d) Real Ltd, an unlevered firm, generates earnings before interest and tax (EBIT) of Sh.20 million in each year. The cost of equity of unlevered firm is 10%. The company is considering use of Sh.40 million, 5% debt to finance an expansion programme.
A consulting firm has estimated that the marginal personal tax rates on ordinary shares income for all investors is 25%. The firm has also estimated that the marginal personal tax rate on debt income is 30%.

Corporate tax rate is 30%.

Required:

Using Modigliani and Miller's arguments: Calculate

i) The current value of unlevered firm. [3 Marks]

ii) The current value of the firm with debt and its weighted average cost of capita (WACC) under assumption of corporate taxes but not personal income taxes. [4 Marks]

iii) The current value of the firm with debt and both corporate taxes and personal income taxes. [4 Marks]

Question Two

a) Examine three types of indirect financial costs that could be faced by firms experiencing financial distresses. [6 Marks]

b) A Ltd has decided to acquire B Ltd. The following are the relevant data for the two companies:

	A	B
Net sales (Million Kshs)	350	45
Profit after-tax (Million Kshs)	28.13	3.75
Number of shares (millions)	7.5	1.5
Earnings per share (Ksh)	3.75	2.5
Dividend per hare (Ksh)	1.3	0.6
Total Market Capitalization (Million Kshs)	420	45

Calculate :

i) Post-merger market value per share and Earnings per share for both companies. [8 Marks]

ii) A's EPS if B's shareholders are offered and accepts one 15 per cent convertible debenture (par value sh.100) for each 3 shares held in B. [6 Marks]

Question Three

a) Explain any four reasons why a company may adopt leasing as a source of long term financing. [4 Marks]

b) XYZ limited company has total capitalization of KES one million and it normally earns KES100,000 before interest and taxes. The financial manager of the firm wants to take a decision regarding the capital structure. After a study of the capital market, he gathers the following data:

Amount of debt (KES)	Interest Rate (%)	Equity Capitalization Rate % (at given level of debt)
	-	10
100,000	4	10.5
200,000	4	11
300,000	4.5	11.6
400,000	5	12.4
500,000	5.5	13.5
600,000	6	16
700,000	8	20

i) What amount of debt should be employed by the firm if the traditional approach is held valid.

ii) if the Modigliani – Miller approach is followed, what should be equity capitalization rate ? Assume that corporate taxes do not exist, and that the firm always maintains its capital structure at book values. [16 Marks]

Question Four

e) Briefly explain the following defense strategies applicable in a hostile takeover situation:

i) Crown jewels strategy [2 Marks]

ii) White Knight Strategy [2 Marks]

a) ABC Ltd is considering whether it would be financially advisable to retire its existing long term debt with a cheaper loan. The current loan of sh.10 million has an annual interest charge of 15% and has 10 years to maturity. The company has Sh.125,000 of unamortized loan expenses still in its books. If the company decides to redeem the loan, there is an early payment penalty amounting to 10% of the loan. A new Sh.10 million loan can be raised at 13% per annum for a ten year period. It is expected that underwriting costs will amount to Sh.600,000. The overlapping interest period between issues will be two months during which interest will be paid on the old bonds and funds borrowed will initially be invested in Treasury bonds at an interest tax of 6% p.a before used for refunding. Assume a tax rate of 30%.

Required:

i) Calculate the net amount of cash investment required for the refunding of the loan. [8 Marks]

ii) Compute the annual cash savings which result from refunding. [6 Marks]

iii) Determine whether refunding is advantageous to the company. [2 Marks]

……………………………………………………………………………………………..